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How the Fed is Invisibly Erasing $38 Trillion in Debt

The Magnitude of the American Debt Crisis

The national debt clock in Times Square presents a figure that is increasingly alarming for the American public, as it has surpassed 36 trillion dollars and is accelerating toward 40 trillion dollars much faster than economists previously predicted. To visualize the scale of 36 trillion dollars, if one were to stack that amount in one-dollar bills, the pile would not only reach the moon but would extend millions of miles further into space. This figure is more than a mere abstract number or a concern for future generations; it represents a financial mechanism that directly impacts current bank accounts, retirement funds, and the economic prospects of future citizens. The government has developed a specific plan to address this debt, which involves a process of silent confiscation of purchasing power rather than traditional methods like raising taxes or cutting spending.

In 2024, a significant shift occurred that broke a 247-year precedent in the history of the United States. For the first time, the federal government is spending more on interest payments for its debt than it is spending on national defense. This means the country allocates more resources to pay bondholders for past debts than it does to equip the military currently protecting the nation. Furthermore, the interest bill has surpassed spending on the Medicaid program, which serves 90 million Americans, and exceeds the combined federal budget for education, transportation infrastructure, and scientific research. The annual interest bill has crossed 1.1 trillion dollars, which breaks down to 3 billion dollars every day, 125 million dollars every hour, and 35,000 dollars every second. This accelerating financial obligation is no longer a partisan political issue but a mathematical trap that transcends political willpower.

The Three Options for Overindebted Nations

Historically, every nation that has accumulated this level of debt relative to its economy has faced three potential paths, and in the modern American context, two of these options are considered politically impossible.

1. Austerity Austerity involves massive spending cuts and aggressive tax increases to balance the budget and pay down debt. To achieve this today, the government would need to double income taxes, eliminate the military entirely, or cut Social Security and Medicare by 40%. Currently, the federal government spends approximately 6.8 trillion dollars annually while collecting only 4.9 trillion dollars in revenue, resulting in a 1.9 trillion-dollar deficit before interest compounds. Closing this gap through taxation alone would require a 40% increase in the tax bill for every American.

2. Explicit Default A government can choose to simply refuse to pay its debts, a path taken by Russia in 1998, Argentina multiple times between 2001 and 2020, and nearly by Greece in 2015.

While survival is possible for some countries after a default, it is considered the nuclear option for the United States because the dollar is the world's reserve currency and the anchor of the global financial system. Global finance is built on the assumption that U.S. Treasury bonds are risk-free; if the U.S. defaults, this foundation shatters. Such an event would likely collapse the global banking system, freeze credit markets, and halt international trade. Because major institutions and nations, including China (holding over 800 billion dollars) and Japan (holding over 1 trillion dollars), as well as American pension funds and insurance companies, hold these bonds, an explicit default would bankrupt retirees and major banks across the Western world.

3. Currency Debasement and Inflation The third option, which history suggests is the preferred choice for overindebted empires, is to pay back the debt in full and on time, but in currency that has significantly less value. This method was used by the Roman Empire through the debasement of silver coins, the Weimar Republic in the 1920s, and postwar Britain in the 1950s. By inflating the currency, the government reduces the real value of the debt it owes.

The Mechanics of Financial Repression

The official, though often unspoken, policy of the United States government is to inflate the debt away by printing the difference and debasing the currency. The mathematical reality is that if the government owes 36 trillion dollars and inflation runs at 5% per year, the real value of that debt—its purchasing power in terms of goods and services—shrinks by 5% annually. In a single year at 5% inflation, the government effectively erases 1.8 trillion dollars of debt without raising taxes, cutting programs, or requiring a vote in Congress. While bondholders receive the exact number of dollars they were promised, those dollars buy 5% fewer groceries, gasoline, housing, and healthcare every year.

Over a decade of 5% inflation, the real value of 36 trillion dollars in debt would be cut nearly in half, becoming worth approximately 22 trillion dollars in today's purchasing power. The resulting 14 trillion dollars in vanished debt is essentially paid for by consumers through higher costs of living. This strategy is known as financial repression: a deliberate policy of keeping interest rates below the rate of inflation to transfer wealth from savers and creditors to the world's biggest debtor, the United States government.

From 1980 to 2020, the Federal Reserve acted as the primary authority of American economic policy, raising interest rates to crush inflation even if it caused unemployment or recessions. An example is Paul Volcker, who in the early 1980s raised interest rates to 20% to protect the currency, despite political backlash and a brutal recession. However, the current debt is so large that the Fed can no longer utilize this strategy. If interest rates returned to 10%, the interest payments on 36 trillion dollars would reach 3.6 trillion dollars per year. Since the government only collects 2.4 trillion dollars in individual income taxes, such a rate hike would make the government mathematically insolvent, causing Social Security checks to bounce and military pay to stop.

The Shift Toward Fiscal Dominance

The Federal Reserve is now trapped and forced to tolerate higher inflation—potentially 4%, 5%, or 6%—because the alternative is immediate government bankruptcy. This environment is described as fiscal dominance, where the Treasury effectively masters the Fed, ending the central bank independence that has historically protected the dollar.

This is not the first time the U.S. has used this playbook. After World War II in 1945, the debt-to-GDP ratio reached 119%. Rather than using austerity or defaulting, the government liquidated the debt through a decade of financial repression. From 1945 to 1955, the Fed capped interest rates at 2.5% while inflation averaged over 6% annually. This resulted in bondholders losing 3.5% of their purchasing power every year, representing a silent wealth transfer to the state. By 1955, the debt-to-GDP ratio was cut in half, not because the nominal debt decreased, but because inflation made it smaller relative to the size of the economy.

Modern Tools of Debt Liquidation

The government currently employs three sophisticated tools to ensure this wealth transfer occurs effectively in the modern era.

Tool 1: The Captive Buyer In a free market, rational investors would demand high interest rates (8% to 10%) to compensate for the risk of lending to an insolvent government. Since the government cannot afford these rates, it has rigged the system through banking regulations implemented after the 2008 financial crisis, such as Basel III, Dodd-Frank, and the Liquidity Coverage Ratio. These regulations force banks, insurance companies, pension funds, and money market funds to hold U.S. Treasury bonds as high-quality liquid assets to meet capital requirements. Consequently, these institutions must buy treasuries to stay in business, regardless of whether the bonds pay less than the rate of inflation. This creates an artificial demand that suppresses interest rates, effectively forcing citizens to lend their retirement savings to the government at negative real interest rates.

Tool 2: The Broken Thermometer To minimize the cost of inflation-adjusted payments—such as Social Security benefits and Treasury Inflation-Protected Securities (TIPS)—the government has an incentive to underreport inflation. Since the 1980s, the methodology for calculating the Consumer Price Index (CPI) has been changed multiple times to suppress the official number.

Methods used to suppress the CPI include:

- **Substitution Bias:** This assumes that if the price of steak rises, consumers will switch to hamburger. The CPI then measures the price of the cheaper alternative, claiming the cost of living hasn't increased as much, even though the standard of living has decreased.
- **Hedonic Adjustments:** If a product like a car or phone costs more but has better features, the government argues the price did not actually rise because the consumer is receiving more value. This allows them to eliminate price increases from the official inflation data.
- **Housing Measurement:** Instead of measuring actual home prices or rents, the government uses owner’s equivalent rent, a survey-based estimate that consistently underreports real housing costs.

If inflation were calculated using the original 1980 methodology, the official CPI today would likely be double the reported figure.

Tool 3: The Money Printer When major foreign buyers of U.S. debt, such as China and Japan, reduce their purchases or begin selling, the Federal Reserve steps in as the buyer of last resort to prevent interest rates from spiking. Through quantitative easing (QE), the Fed creates money out of thin air to buy Treasury bonds. This keeps borrowing costs low for the government but increases the money supply, which dilutes the value of existing dollars.

This influx of money creates an everything bubble where the stock market and real estate prices rise not because of increased value or productivity, but because more dollars are chasing the same number of shares and houses. While people may feel wealthier because their 401k balances or home values appear higher on paper, they are not actually wealthier because each dollar they own is worth less. The government is essentially paying its debts by diluting the value of every dollar in bank accounts, paychecks, and retirement funds.

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To clarify these economic mechanics: think of the U.S. government as a homeowner with a massive mortgage they cannot afford to pay back with their current salary. Instead of getting a second job (austerity) or letting the bank take the house (default), they convince the bank to use a different ruler to measure the debt—one where the inches get shorter every year. Eventually, the homeowner "pays back" the full number of inches, but those inches no longer represent the same amount of land they did at the start.